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DIRECTORATE OF  
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# Intelligence Memorandum

*Liberia: Current Economic Problems*

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ER IM 68-31  
MARCH 1968

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CENTRAL INTELLIGENCE AGENCY  
Directorate of Intelligence

INTELLIGENCE MEMORANDUM

Liberia: Current Economic Problems

Summary

Liberian officialdom is currently deeply concerned with the country's pressing foreign debt servicing problem, and the question of stretching out debt payments is almost certain to be raised during President Tubman's late March visit to Washington. Liberia fears it will be unable to meet the scheduled payments over the next few years with the revenues it now expects. Some International Monetary Fund (IMF) officials suggest that Liberia could increase its revenues by imposing new taxes, by efficiently collecting those already on the books, and by renegotiating concession agreements. It is far from certain that the government would do all this, or that if it did the resultant revenues would be adequate to service the debt. In any event, the currently scheduled payments are quite onerous in terms of Liberian revenues. The total national budget, for example, is considerably smaller than that of Arlington County, Virginia. The \$17.9 million payment due next year is equivalent to about 40 percent of the government's anticipated current revenues, and Liberia hopes that it can be reduced by about \$3 million and that subsequent payments can also be adjusted.

In 1963, Liberia was successful in having its foreign debt rescheduled, with the aid of the IMF, in return for undertaking to introduce a number of

*Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of Current Intelligence.*

fiscal reforms that would have controlled current spending and increased current revenue to assure adequate funds for debt servicing. Few of these reforms were implemented, however, and in the interim the prices of rubber and iron ore, Liberia's major exports, fell below expectations and government revenues dropped.

Liberia's foreign debt now totals almost \$200 million, more than one-half of it owed to the US Government. Much of the rest is high-interest, relatively short-term loans which have financed many projects that are not self-amortizing and have contributed little to economic development. Economic growth has occurred, but it is almost entirely attributable to private foreign investment.

The monetary economy -- consisting largely of rubber plantations and iron mines built by foreign capital -- has grown rapidly over the past 15 years and is expected to continue to expand, although at a slower rate. The oligarchy which runs the country has benefited handsomely from its share of the profits. Government expenditures have also grown rapidly but have had relatively little impact on economic development. The level of public health, education, and services to peasant agriculture remains one of the lowest in Africa. Most of the population is still in the subsistence sector and largely untouched by the money economy. Although there is considerable room for expanding food production to cover domestic consumption, obstacles are numerous. Liberia's small potential local market also hampers expansion of manufacturing and processing industries.

While lower debt payments and additional aid would ease the immediate financial problem, Liberian revenues for the next few years are likely to cover only current expenditures, and the amount available from government sources for development would be almost nil. Development funds would have to come from foreign investment and/or foreign aid. Even if such funds become available, however, economic progress will be impeded by the rigid oligarchy which has demonstrated little real interest in development and has proved to be unwilling to alter existing economic patterns that work to its financial advantage.

The Nature of the Economy



*President Tubman*

1. The million-plus inhabitants of Liberia are ruled by an oligarchy of 20,000 Americo-Liberians, descended largely from freed American slaves who were settled along the coast in the early 1800's. Their culture and customs are patterned after those of the ante-bellum American South; their conservatism is perhaps even greater than that of their model. Together with their spokesman, President William V. S. Tubman (first elected in 1944), they hold all the major government positions, control almost all the domestic wealth of the country, and derive

their substantial incomes largely from their positions or connections. Their control is pervasive and exercised formally through the True Whig Party, which has been in power continuously since 1878. With the help of several thousand foreign experts and managers, they run the modern economy. The consistent dominance of this small elite has resulted in a political stability unusual for Africa, which has in turn attracted considerable foreign investment.

2. In Africa, Liberia is viewed as a protégé of the United States, and American interests dominate the economy. US investment totals about \$350 million and is probably surpassed in Sub-Saharan Africa only by US investment in the Republic of South Africa. American-owned banks handle most financial transactions; a wholly-owned subsidiary of the First National City Bank of New York acts as the country's central bank, and Liberia uses the US dollar as its currency. About 3,500 Americans work or live in Liberia, and more than one-third of them are connected with US government activities. More than one-half of the 1,500 ships registered under Liberia's flag of convenience are American owned. The United States is also Liberia's major trading partner and by far the largest source of aid.

3. In return for a quasi-defense arrangement, Liberia allows US military forces to use the American-built international airport at Roberts Field and the American-built port facilities at Monrovia. US Government installations include a \$15 million Voice of America transmitter

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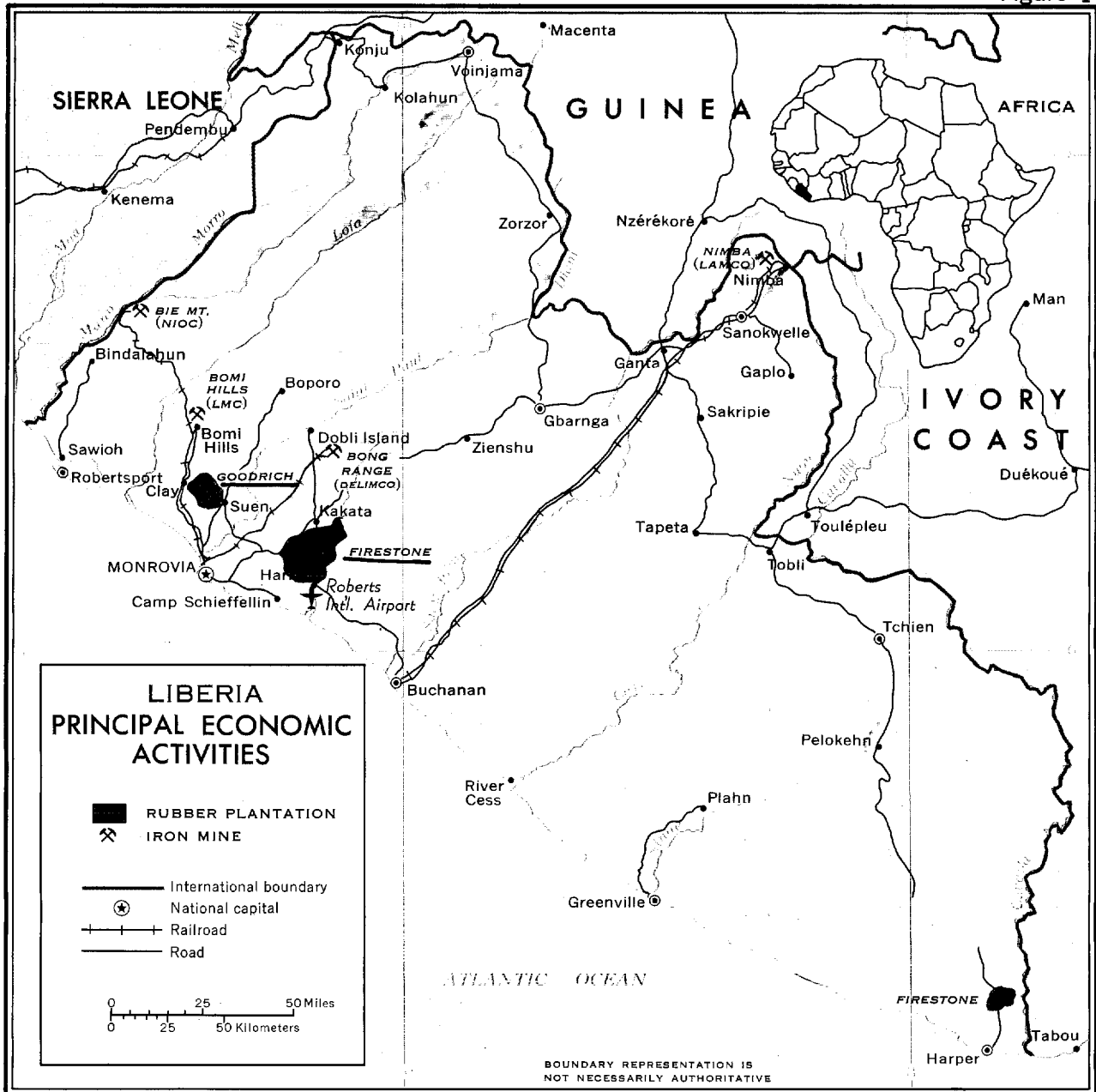
Since 1946 the United States has extended about \$270 million in economic aid\* -- one of the largest US aid commitments in terms of per capita assistance -- and has supplied numerous technicians and experts.

4. The modern sector of the economy consists largely of four iron mines built and run by foreigners, four rubber plantations in production financed largely by American firms, a few Americo-Liberian rubber farms, and the government establishment (see Figure 1). Together, rubber and iron ore operations account for about 90 percent of the country's exports, directly provide more than 25 percent of government revenues and indirectly much of the rest, and employ more than 55 percent of the wage earners (see Figure 2). Output has grown rapidly since World War II. In the 15 years between 1951 and 1966, estimated gross national product increased between 5 and 10 percent a year. Government revenues more than tripled over the period. This growth can be attributed almost wholly to the influx of private investment, which now totals about \$550 million. Employment on the rubber plantations, and to a lesser extent in the iron mines and in government services, has brought about one-third of the population at least partly into the monetary economy. Nevertheless, almost all skilled and semi-skilled positions, including even wholesale and retail trade, are held by foreigners.

5. Since 1962, iron ore exports have become the most important source of foreign exchange, and investment in mining over the past decade has fueled most of Liberia's growth. In 1964, for example,

\* Including about \$60 million in Export-Import Bank loans to mining companies.

Figure 1



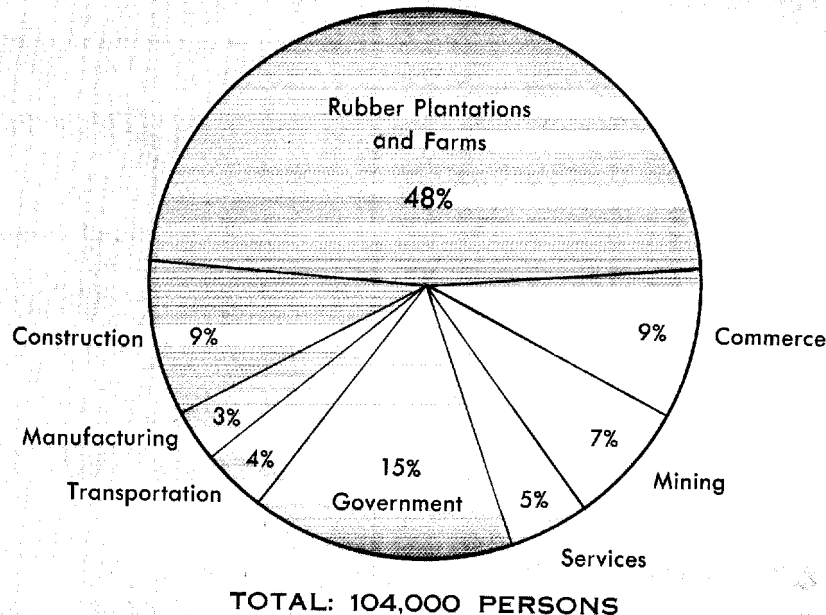
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Figure 2

**LIBERIA: ESTIMATED DISTRIBUTION  
OF THE WAGE LABOR FORCE, 1967**



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iron mining accounted for about a fourth of estimated gross domestic product (GDP). Exports have risen rapidly in volume but the world price has dropped steadily since 1960 (see Figures 3 and 4). Liberian iron ore sold for \$6.40 per long ton in 1966, for example, compared with about \$11.90 a ton in 1960. Consequently, although output has grown fast enough to keep the value of exports rising despite declining prices, Liberia's over-all earnings from iron mining have fallen far below its expectations, and this is the root cause of much of the country's current financial difficulty.

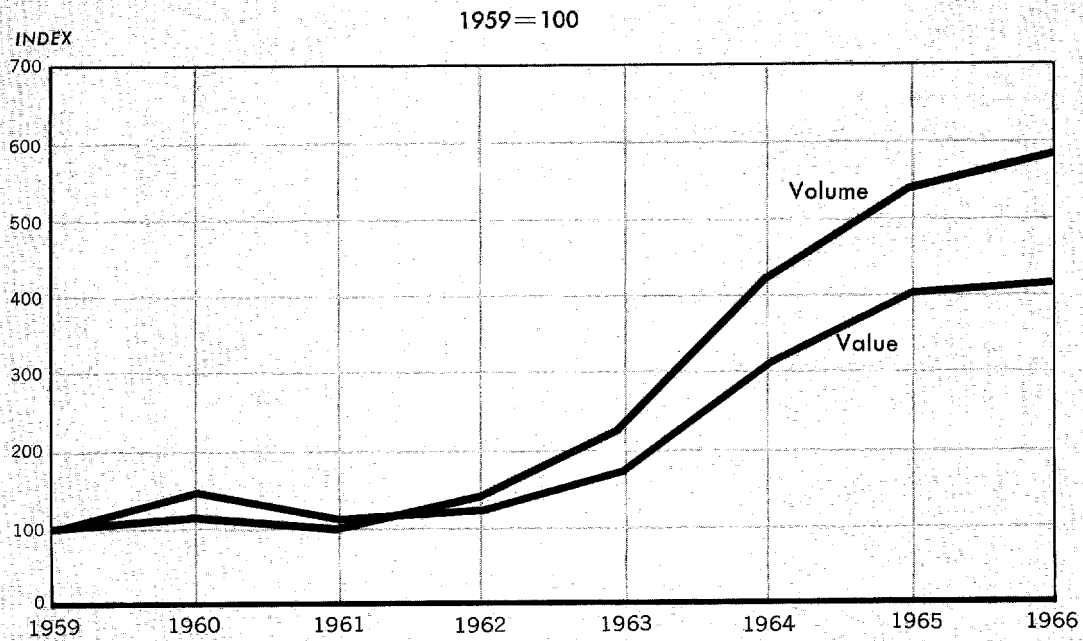
6. Iron ore prices are not expected to recover over the next few years but the total value of exports will probably continue to rise because output is slated to expand. The Liberian American-Swedish Minerals Company (LAMCO),\* the largest

\* *An affiliate of Swedish mining interests and Bethlehem Steel.*

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Figure 3

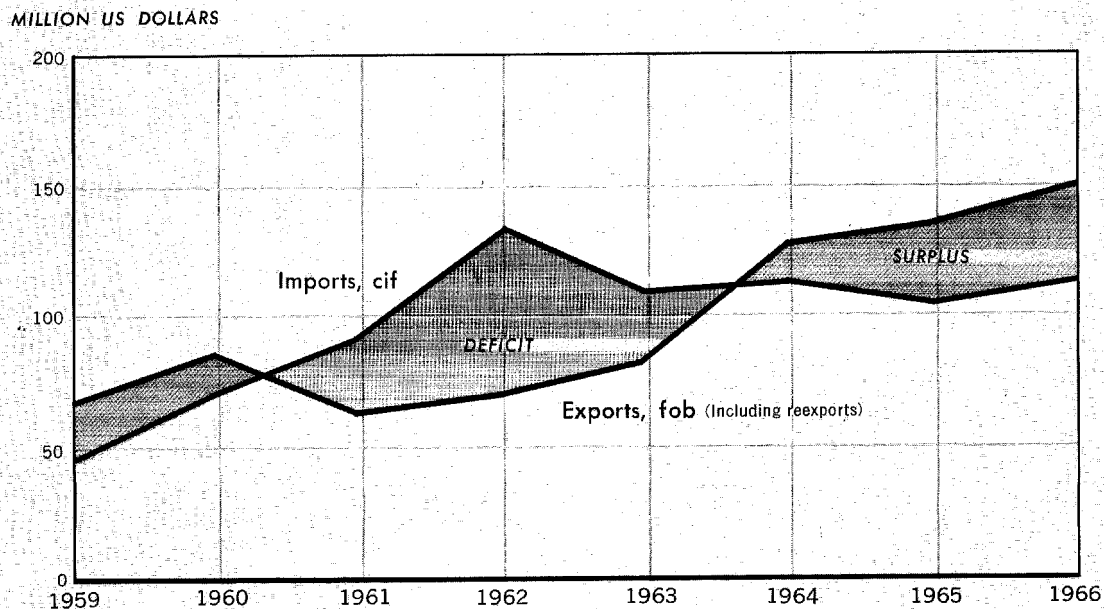
# LIBERIA: IRON ORE EXPORTS, 1959-66



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Figure 4

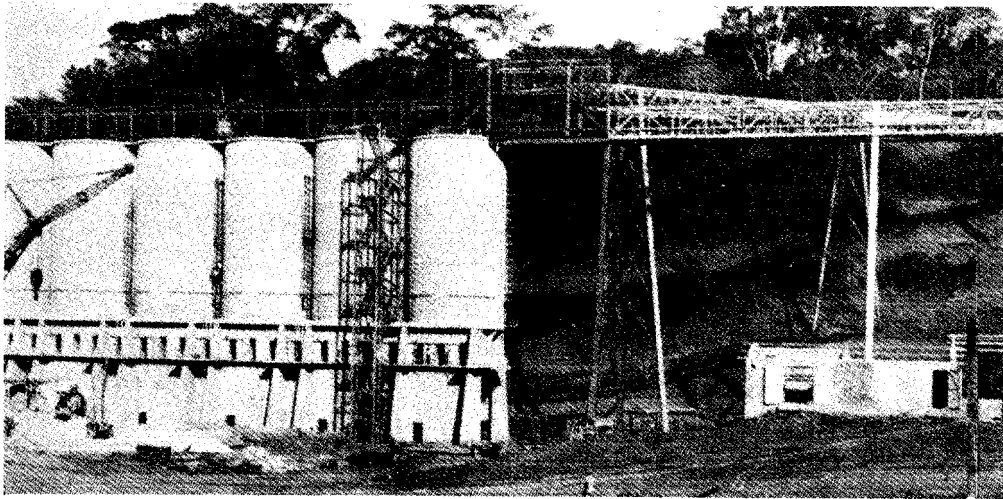
# LIBERIA: EXTERNAL TRADE, 1959-66



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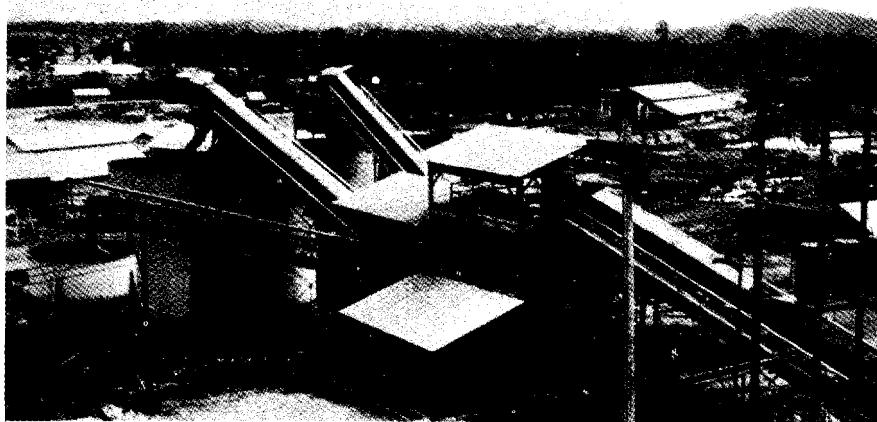
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*LAMCO Iron Ore Loading Bins in the Nimba Mountains*  
producer, recently completed a \$57 million pelletizing plant which should bring Liberian exports to about 20 million long tons this year. The company also expects to begin feasibility studies for another mining site in the near future.

7. The three mining concessions,\* each owned 50 percent by the Liberian government, and the Liberia Mining Company (LMC), controlled by Republic



*Liberian Mining Company's Iron Ore Mine  
in the Bomi Hills*

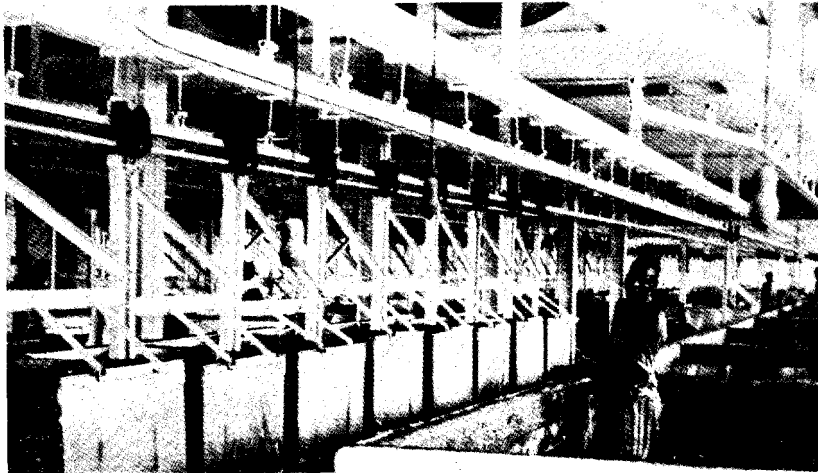
\* LAMCO, the German Liberian Mining Company (DE LIMCO), and the National Iron Ore Company (NIOC).

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Steel, all pay half their net profits to the Liberian government. They repatriate most of the remainder, however, and are currently servicing sizable loans with a relatively rapid payoff so that their net contribution to the economy is considerably smaller than the value of their output might suggest.

8. Rubber is the only important agricultural export. From the mid-1920's until the early 1960's and the opening of the iron mines, the Firestone plantation was the single most important economic factor in the country. The volume of rubber exports



*Firestone Rubber-Processing Plant*



*Liberian Privately-Owned Rubber Factory*

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has risen fairly rapidly over the past decade, but as in the case of iron ore, the world price has fallen drastically. In 1967, for example, the world price for natural rubber averaged about 18 cents a pound, less than half the 1960 price.

9. Production is expected to continue to increase as new plantings of high-yielding stock begin to bear. Two new plantations, including one owned by the US Rubber Company, will come into production within the next several years. Moreover, Firestone, B.F. Goodrich, and the African Fruit Company all have sizable acreages in trees that are not yet producing. (For data on rubber production in Liberia during 1960-67, see Table 1.)

10. Partly with Firestone's assistance, Liberians in increasing numbers have taken to growing rubber. The Americo-Liberians are usually the absentee owners of the larger and more successful farms. Almost two-thirds of the 4,000 rubber farms cover less than 20 acres and are generally very inefficient. The quality of their output tends to be much lower than that on the plantations and, for many, earnings have fallen below production costs in recent years. This is partly due to inefficiency in tapping and partly to their failure to replace older trees with new high-yielding varieties that can produce four to five times as much latex per tree. In November 1967, President Tubman announced a price support program for small rubber producers to be financed through interest-free loans from the rubber concessionaires. The program may keep many growers in production, but it will reduce the incentive to improve their holdings.

11. Seven or eight small diamond dealers buy from African diggers and from smugglers who handle "tourist" diamonds from Sierra Leone and Ghana. Diamonds, however, account for only about 2 percent of total exports. Coffee is similarly smuggled in from neighboring territories and exported as Liberian produce. Only about one-third of the coffee exported is actually grown in the country. Coffee exports are likely to drop sharply because Liberia recently joined the International

Table 1

Liberia: Rubber Production  
Selected Years, 1960-67

	<u>1960</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u> a/
<u>Individual Farms</u>					
Cultivated acres in production	49,000	63,260	69,000		
Cultivated acres not in production	37,000	64,525	63,100		
Total acres cultivated	86,000	127,785	132,100		
Output (long tons, dry rubber content)	6,439	8,749	12,628		
<u>Concessions</u>					
Cultivated acres in production	68,636	76,890	81,055		
Cultivated acres not in production	27,034	49,440	51,816		
Total acres cultivated	95,670	126,330	132,871		
Output (long tons, dry rubber content)	35,751	34,283	37,180		
<u>Total</u>					
Acres cultivated	181,670	254,115	264,971		
Output (long tons, dry rubber content)	42,190	43,032	49,808	54,553	60,250
a. Estimated.					

Coffee Organization and was assigned a fairly small export quota which approximates estimated domestic production. Liberia also produces insignificant quantities of palm kernels, cocoa, and piassava for export. Soils and climate are suitable for a considerable expansion of agriculture, but the development of cash cropping has hardly begun.

12. The government establishment, centered in Monrovia, is the second largest employer after the rubber plantations. Government personnel number about 16,000, and the payroll is the largest in the country, more than \$17 million a year. Infrastructure and services are largely confined to the capital city and its environs and to the rubber plantations and iron mines. Schools, medical facilities, roads, and other such facilities are rare outside the productive enclaves and the capital.

13. Between one-half and two-thirds of the population is relatively isolated from events in the modern economy and depends almost entirely on traditional agriculture. Rice and cassava are the staple foods, rice being favored in urban and plantation areas. Domestic production of cassava has probably kept up with population growth, but production of rice remained fairly constant over the past decade although demand has increased. As a result, Liberia now imports almost 40 percent of the rice it consumes. There is little local incentive to raise output because farmers often have no way to get their crop to rice mills. The few mills are privately owned by Americo-Liberians who often impose a milling charge of 25 percent of the retail value of the rice.

14. There is considerable room for expanding food production, diversifying cash crops, and exploiting forest reserves, but obstacles are numerous. Roads to market are few and poorly maintained, agricultural credit facilities are practically non-existent, and peasants lack good seed, modern tools, and insecticides. Draft animals are rare, principally because of disease. Moreover, in many areas, corruption and extortion on the part of police, army, and tax collectors provide a positive disincentive to increase production.

15. Peasant agriculture has received very low priority in government spending. Although President Tubman announced a crash \$2 million development program in November 1967, principally to promote rice production, little is likely to come of it. Significant development of peasant agriculture awaits considerable investment in infrastructure -- including roads and marketing facilities -- and the establishment of agricultural credit facilities. Moreover, real progress would require an end to the corruption and extortion and the provision of positive incentives for increased production, none of which now seems likely.

#### The Debt Problem

16. Liberia's most visible financial problem is the burden of repaying its foreign debt. The principal now totals almost \$200 million. Approximately \$157 million was incurred by 1963 to finance a wide variety of projects, including public buildings, schools, and roads, but relatively few of them were self-amortizing. Worse yet, many of the loans were short-term or medium-term at interest rates up to 10 percent.

17. In 1963, Liberia was faced with an annual payment of \$33.5 million, the equivalent of about 90 percent of government revenues for that year.\* Since it was clearly impossible to pay this much, the government appealed to the IMF for financial aid and assistance in rescheduling the debt. As a result the payments were stretched out over 15 years and the IMF has provided stand-by loans each year since 1963 (see Table 2). The rescheduling was predicated on a rise in Liberian government revenues and on strict control over current expenditures. Revenues failed to increase as projected, however,

\* *Liberian statistical and accounting services are negligible. Statistics on government revenues and expenditures from apparently reliable sources are both internally self-contradictory and differ so widely that such figures used in this section should be regarded only as approximate.*



Table 2

Liberia: Debt Servicing Schedules  
1963-82

Million US \$			
<u>Year</u>	<u>Pre-1963 Debt Payment Schedule</u>	<u>Rescheduled Payments Including New Borrowing <u>a/</u></u>	<u>Proposed Second Rescheduling <u>b/</u></u>
1963	33.5		
1964	18.3		
1965	19.1		
1966	17.2		
1967	13.5		
1968	10.6	12.1	12.1
1969	8.7	17.9	14.8
1970	6.8	17.5	14.6
1971	5.4	16.8	14.1
1972	5.5	15.1	13.0
1973	3.6	14.4	12.2
1974	3.0	15.6	13.4
1975	2.6	12.9	12.1
1976	2.2	12.6	17.1
1977	2.0	11.3	15.7
1978	Negl.	7.9	16.5
1979	Negl.	5.5	14.8
1980	Negl.	5.3	12.3
1981	Negl.	Declines	9.0
1982	Negl.	to Negl.	7.1

*a. Excluding IMF.*

*b. Assuming a roll-over in payments due IMF until at least 1978.*

largely because rubber and iron ore prices declined, thus depressing company profits and income tax payments. Also, Liberia failed to implement all of the IMF-sponsored fiscal reforms designed to increase tax collections. Some reforms were adopted, although with disappointing results. The government undertook to restrain the increase in current spending (excluding debt service) to 5 percent a year or less in order to make funds available from ordinary revenue for debt service, but current spending in 1965 and 1966 rose by 10 percent or more each year. Expenditures increased in 1967, but it is not yet clear by how much.

18. Liberia, however, has generally refrained from new borrowing from suppliers and contractors. This type of high-interest, short-term debt led to the severe financial crisis in 1963. New foreign debt incurred since early 1963 is largely the result of refunding existing debt and long-term, low-interest loans from AID. For example, outstanding debt to the United States increased about \$40 million between the renegotiation and the beginning of 1968. Of this, more than \$18 million was AID loans for such projects as schools, technical assistance, a sewage system for Monrovia, and the Public Utilities Authority. Assumption of responsibility for the Port of Monrovia added another \$19 million to Liberian debt, although it is to be repaid over a very long time into a joint US-Liberian fund for education and culture. The balance of the increase in debt to the United States was made up by PL-480 loans and military assistance.

19. Total debt outstanding increased only about \$34 million since early 1963 to about \$200 million. Of this, more than \$13 million was owed to the IMF for stand-by assistance.

20. Liberia apparently met the payment schedule for 1964 through 1967 which seems to have averaged about \$10 million a year, the better part of which was interest. These payments were slightly higher than originally scheduled because of additional borrowing and were made partly through using IMF stand-by assistance and a \$13.3 million refunding loan from the Export-Import Bank.

21. According to the current debt schedule, Liberia is to pay about \$6 million more in 1969 than in 1968. The government is now seeking US support for a second debt rescheduling on the grounds that it will have great difficulty in meeting the payments scheduled for the next several years. A good part of the existing debt -- about \$40 million -- is in the form of bearer notes originally issued to companies and individuals but sold at discounts to banks and other individuals after the first rescheduling in 1963. The following tabulation shows the composition of outstanding government external debts in early 1963, before rescheduling of the outstanding debt, and as of 1 January 1968:

	<u>Million US \$</u>	
	<u>1963</u>	<u>1968</u>
United States Government, including Export-Import Bank <u>a/</u>	62.6	102.0
West German Government	15.7	17.4
United Kingdom Government	0	0.6
International Bank for Reconstruction and Development	3.2	4.3
Commercial banks	15.5	15.1
Bearer notes and sundry accounts	60.4	38.5
Total, excluding IMF	<u>157.4</u>	<u>177.9</u>
IMF stand-by loans	<u>0</u>	<u>13.4</u>
Grand total	157.4	191.3

*a. Principal owed to the US Government excludes more than \$60 million loaned by the Export-Import Bank to mining companies in Liberia and carried in the bank's reports as loans to Liberia. Export-Import loans to the government are included.*

Liberia is reluctant to ask renegotiation of payments on these notes because of the cost of finding and negotiating with the scattered holders, because it fears this would severely damage its credit rating, and because the interest rates are so high that further postponement would be exceptionally costly. It hopes, instead, with US and IMF

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assistance to reschedule payments to the US Export-Import Bank, the German Kreditanstalt, and commercial banks. Liberia proposes to pay only half the principal due on these loans from 1969 through 1975 and to pay the deferred amounts from 1976 to 1982. Although this would add more than \$10 million to total interest payments through 1982, it would reduce the annual debt servicing level to \$14.8 in 1969 and \$14.6 in 1970, about \$3 million lower in each case than currently scheduled payments. This reduction is about equivalent to one-half the payments due the US Government in these two years.

22. Liberian officials predict that rising revenues from public corporations like the Port Authority will average more than \$2 million annually through 1973. If this sum were set aside for debt servicing, it would leave only about \$12 million to \$13 million to be met from ordinary government revenue over the next few years. Whether Liberia could meet the reduced payment levels it proposes would depend on its budgetary policies, the levels of rubber and iron ore prices, and on the amount of financial aid it receives.

23. If Liberia controls current spending and implements most of the IMF suggestions for increasing internal revenues, it probably can meet the proposed revised schedules. IMF advisers believe that reforms could yield as much as \$7 million a year in additional government revenues which would enable Liberia to meet the currently scheduled payments. IMF recommendations include the extension of the 4.5 percent austerity tax to non-Liberian residents in the country; the raising of the minimum corporate income tax; the application of withholding tax on dividends, interest, and royalty remittances to non-Liberians; and finally renegotiation of the concession agreements.

#### Prospects

24. Whatever the outcome of Liberia's current efforts to reduce the debt servicing burden, its overall economic prospects depend on what happens in the plantation and mining sectors and on Liberian government policies toward development of the traditional sector. Perhaps the most crucial factor is how the government handles its revenues and expenditures over the next decade or so.

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25. Unless revenues from mining, plantations, and the rest of the money economy increase substantially -- and this does not seem likely -- the government will have only a modicum of development funds from its own resources. Debt rescheduling and/or a revenue increase as great as that suggested by the IMF recommendations could free some funds for investment in infrastructure and agriculture. Without one or both, investment funds from internal sources would be negligible. Even if a revenue surplus became available for the capital budget, there is little assurance it would be so used. Government spending habits are deeply entrenched, and so long as the present administrative system is maintained, current expenditures will tend to equal or surpass revenues. Development, then, is likely to become chiefly a function of the amount of foreign aid or investment devoted to increasing output.

26. A major government effort to expand agriculture by integrating the traditional sector into the monetary economy would probably be the best route to development. It would, however, involve a substantial investment in infrastructure, marketing facilities, and agricultural credit for the benefit of the farming community at large. But the ruling oligarchy cannot be expected to make basic reforms that would adversely affect its own fortunes, and, to date, it has shown little real interest in making the kind of effort that could promote general economic development. There are, however, an increasing number of young, educated, tribal and non-tribal Liberians who feel a growing sense of frustration with the establishment. In time, these elements are expected to play an increasing role in the political and economic life of the country. But change is likely to come slowly.

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DATE: February 15, 1968

SUBJECT: Status of Spanish Economy: 1967 Results and Outlook for 1968

REF :

SUMMARY

The Spanish economic outlook for 1968, following a year of severe economic problems which culminated in the November devaluation and adoption of a long-delayed austerity program, is extraordinarily troubled. The problems of inflation, the serious decline in the rate of investment, and the continued balance of payments disequilibrium, at which the devaluation and austerity program were aimed, will continue to menace the economy in 1968. Price stability--the objective of the current freeze on prices and incomes--is prejudiced by the need to assimilate the internal price effects of the devaluation in an import-oriented economy. Although the GOS has taken some measures of a fiscal and monetary nature to stimulate private investment, the reversal of the present decline will be extremely difficult in the face of the severe fall in investor confidence which seems to have worsened in recent weeks. In the absence of any hope of a prompt rejuvenation of private investment, the GOS plans a substantial increase in public sector investment, particularly in housing and public works, and has reduced its growth target for 1968 from 6.0 to 4.5 percent of GNP. While there is still hope for some balance of payments benefit from the devaluation, the U.S. Program has come as a severe blow to Spain, and some GOS officials fear that the direct and indirect effects of the U.S. measures may cancel out much of the advantage Spain had expected from the creation of a cheaper peseta.

Perhaps the most serious problem facing the economy is lack of

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public confidence in the Government's economic policy makers and the continued absence of meaningful coordination of GOS economic policy. Last fall's rumors concerning an imminent change in economic leadership have not come to fruition, and it now appears that there will be no cabinet changes in the near future.

As a companion piece to this narrative, the Embassy is transmitting separately a comprehensive list of the economic measures adopted by the GOS over the past 18 months.

\* \* \* \* \*

### I. 1967 in Review

1967 was the most disappointing year experienced by the Spanish economy since the inauguration of the Stabilization Plan in 1959. The persistent problems of domestic price inflation and balance of payments disequilibrium, which have plagued the economy since 1965, were joined in 1967 by a marked slowdown in activity in certain major industries and an alarming absolute decline in industrial investment.

#### Inflation

While the official cost of living index registered an increase of 6.4 percent in 1967, Embassy officers have been told by several GOS officials that the actual increase in the official index was on the order of from 7.0 to 7.5 percent. In any case, the archaic official index is a grossly inadequate device for measuring present living costs, and the true increase in the cost of living for the average urban Spaniard was undoubtedly even higher--perhaps as much as twelve percent. (The Embassy has been reliably informed that a plan to adopt in November 1967 the new, more representative cost of living index which has been under trial for some months was abandoned because the new index registered a cost of living increase of more than three percent in that one month alone.)

As in the preceding two years the major inflationary impetus in 1967 came from increases in public and private wages far in excess of productivity gains and from rising Government current expenditures. Wages increased in 1967 by some 12.6 percent over 1966 for a total increase in the period 1964 through 1967 of 90.2 percent; during the same period productivity per worker increased only by an estimated 22.7 percent. At the same time public sector consumption increased by some 17 percent in 1967, contributing to an intensification of the inflationary breakout which had menaced the Spanish economy since 1965.

#### Slowed Growth Decline of Investment

Paradoxically, price inflation was accompanied in 1967 by a significant decline in demand among certain industries of the productive sector. The

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seriousness of this decline in productive activity was pointed up sharply by the recently released Planning Commission estimate that Gross Domestic Product for 1967 increased by only 3.7 percent. Although this would be a fairly acceptable rate of growth for many countries, in the case of Spain, which has been accustomed to growing at an average rate of eight percent of GNP per year since 1960, it represents near stagnation.

Industry turned in the most disappointing sectoral performance, the 4.1 percent reported growth in output from this sector in 1967 being the lowest since implementation of the Spanish economic reform program in 1960. Moreover, the Embassy has been told by GOS officials that the actual, in contrast to the official, rate of growth for the sector may have been substantially lower than the reported 4.1 percent. Certain industries were harder hit than others by the drop in demand in 1967 with the capital goods, textile, and extractive industries recording a particularly bad year.

Of greater long-term concern, was the decline in investment experienced in 1967. While no final figures are available for gross investment, there was apparently a notable decline from the high rates of recent years during which gross investment has been running at more than 25 percent of GNP. Construction activity, for example, was reportedly down by approximately thirty percent in 1967. In the industrial sector, Ministry of Industry LOPEZ BRAVO has reported that there was an absolute decline of 4.7 percent in fixed investment from the level of 1966. As one of the effects of the decline of industrial investment, Sr. Lopez Bravo announced that only 70,000 new jobs were created in the industrial section in 1967, a sharp decline from the 180,000 jobs created in 1966.

#### Balance of Payments

The GOS has reported a 1967 balance of payments deficit of \$126 million (as measured by the loss of reserves)--a substantial improvement over the \$228 million loss of reserves suffered in 1966. In this connection, recent contacts with GOS officials have confirmed earlier reports that illegal capital flight had risen alarmingly prior to the devaluation (perhaps as much as \$200 million was lost in the weeks preceding November 19), whereas most, if not all, of this money returned after the devaluation. It now appears the swing was sufficient to bring the 1967 deficit even below the \$150 million level being forecast at the beginning of the last quarter of 1967.

The devaluation aside, the 1967 improvement in the international balance can be attributed to two further factors: a proportionately small, but marginally important reduction in Spain's massive commercial deficit; and an increase in long-term private capital inflows. The trade deficit declined some 9.3 percent from the \$2,337.2 million of 1966 to \$2,119.5 million in 1967, as a result of a 12.6 percent increase in exports and a 1.7 percent decline in imports from 1966 levels. This reversal of the sharp uptrend of imports of the past several years was due in part to a moderate decline in import demand, reflecting the fall in investment and the slowed pace of economic activity, but perhaps more importantly (if transiently) to the success of the GOS administrative efforts to restrain imports through

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4

restrictive changes in tariff classifications and deliberate delays in the issuance of import licenses.

On the other hand, tourism, which has customarily been relied upon to cover a major part of the trade deficit, was a distinct disappointment in 1967. While the number of tourists entering Spain was up slightly by 3.5 percent over 1966, earnings from tourism dipped by 2.6 percent--a sharp reversal of the rapid annual growth of tourism earnings since 1960. Moreover, because of the reduced rate of economic activity in northern Europe in 1966, remittances to Spain from Spanish workers in these countries also dropped sharply. Through November 1967, total remittances were \$414 million, a 7.7 percent decline from the \$446 million recorded for the same period of 1966.

The decline in invisibles earnings was largely offset, however, by a fortuitously timed increase in foreign investment traceable to the bunching of a few very large scale investments. Preliminary foreign investment figures for 1967 show a gross inflow of \$421 million, a 32.3 percent increase over the \$318 million received in 1966.

## II. Prospects for 1968

By the fall of 1967, it was apparent that strong Government action was necessary to restore equilibrium in the domestic economy and in the balance of payments as well as to overcome the severe decline in public confidence which was both a cause and a result of the sagging demand and investment falloff in the productive sector. The British devaluation of November both threatened to intensify Spain's own balance of payments difficulties and presented the GOS with a politically opportune moment to take some long-needed therapeutic measures in the domestic economy. The Spanish devaluation of November 19 and the accompanying austerity program have three principal objectives: 1) the restoration of equilibrium in the balance of payments; 2) the halting of the rapid rate of inflation in the domestic economy; and 3) the stimulation of investment. While there is general agreement within and without the Government on the need for strong measures, such as those contained in the austerity program, to restore health to the economy, there is an accompanying skepticism whether the same policy-makers who led Spain down the easy road to inflation and devaluation are capable of leading it up the rocky path to balanced growth. It is this general lack of confidence in the economic leadership of the Government and in its economic program which presents the greatest threat to the Spanish economy in 1968.

### Government Objectives for 1968

Domestic: With regard to the domestic economy, the Government's 1968 objectives are the restraint of inflation and the selective stimulation of investment--in other words to redivide available resources with a larger

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share going to investment and a smaller one to consumption. The major anti-inflationary instrument is the one-year freeze on personal income and prices. While the wage freeze has thus far been fairly effective, the Government's ability to hold the line against demands for wage increases is directly dependent on its success in preventing any sharp increase in the cost of living. The Spanish Syndicate Organization has publicly stated that it cannot tolerate an annual increase in the cost of living of more than 2.5 percent if it is to refrain from pressing for wage increases for its members. The official cost of living index was reported to have remained stable in December, a development hailed by the GOS as proof of the effectiveness of the austerity program. However, in addition to the known inadequacy of the official index, several GOS officials have privately intimated to the Embassy that the results of the monthly price survey are not beyond manipulation to show the results desired by the GOS. While the December results may or may not have been doctored it will become increasingly difficult to prevent increases in the cost of living as the year progresses. The inflationary impact of the devaluation on the cost of living is only now beginning to become apparent, and the GOS was recently compelled to establish procedures under which the prices increases for goods with a heavy import content may be authorized.

There are also numerous reports that the prices of many imported goods, particularly non-foodstuffs, were raised immediately after the devaluation and that the Government, despite the supposedly all-inclusive nature of the price freeze, took no action. As was reported at the time of the devaluation, Spain, at its present juncture of development, is perforce an importing country and the overwhelming percentage of its imports are essential goods, such as foodstuffs, raw materials, and capital goods. Hence, a large part of the increase of 16.7 percent in the cost of these imports must inevitably be passed on to the Spanish consumer. The Government has increased its subsidies for foodstuff imports to restrain the effect of such higher costs on consumer budgets; but the over-all outlook is for at least some increase in prices and the cost of living over the next several months. Indeed, while preliminary information on the Second Development Plan is that a maximum increase of 2.5 percent is forecast in the cost of living, all officials with whom Embassy officers have discussed the question of prices agree that it will be impossible to prevent an increase in the price level considerably in excess of this figure.

Additional cause for concern about price stability arises from the 1968 national budget which, despite official recognition of the need for public sector participation in the austerity program, projects current expenditures at a level 8.4 percent higher than in 1967. The 1968 Budget indeed illustrates that the GOS has unfortunately not yet met its own responsibility to reassess public sector spending priorities in the light of the need to restrain consumption demand and to increase investment in the economy, and that the over-all impact of public sector spending in 1968 will continue to be inflationary.

The second major objective of the domestic economic program--the stimulation

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6

of investment--has acquired even greater urgency with the recent revelation by the Ministry of Industry that investment in the industrial sector in 1967 declined 4.7 percent from the level of 1966. There are, however, several obstacles to be overcome in order to achieve an increase in investment levels. Perhaps the most critical of these is the economic uncertainty and general lack of investor confidence which appeared during 1967 and which has intensified in the weeks since the devaluation. Any assessment of investment climate is always difficult, but recent conversations with GOS officials (representing each of the several economic ministries) as well as Spanish and American businessmen clearly indicate an increased reluctance to commit new foreign and domestic investment capital in Spain. It indeed appears that this generally bearish investment climate may become a more important brake on foreign investment than the restrictive effects of the U.S. balance of payments program.

The delay in the initiation of the Second Development Plan, originally scheduled for January 1, 1968 and now postponed until after April 1 in order that it can be revised to take into account the devaluation and austerity program has further heightened investment uncertainty in the economy. Lacking definite knowledge of public sector investment, private investors are encouraged to postpone their own investment plans. Moreover, the Planning Commission itself has come under increasing attack since the devaluation for the all too obvious failure of the First Plan to provide balanced economic growth, and the efficacy of the Second Plan is hence publicly suspect even before it is published.

In the meantime, the GOS is taking fiscal and monetary action under the austerity program in an attempt to stimulate private investment. Major fiscal incentives are the liberalization of depreciation allowances and the exemption of reinvested earnings from the surtax on corporate profits imposed under the austerity program. Monetary measures include: an increase in the interest rate on term deposits; the creation of a special one billion peseta line of discount for purchases of machine tools; and the reduction by five percent of the minimum percentage of the deposits of savings banks which are required to be held in Government certificates of investment.\* The investment problem in 1968, as in 1967 when the GOS also pursued a generally expansionist monetary policy, is however seen as one of a lack of demand for investment funds rather than a shortage of investment credit.

One political measure is under continuing discussion which could have a significant effect on the willingness of investors to commit funds. This involves the proposed easing of the legal procedures for the reduction of labor forces in order that companies might maximize gains from new capital investment. This has become, however, a thorny political issue since granting employers the right to dismiss employees would almost certainly intensify worker demands for the right to strike--a right now denied by the Spanish regime. (The fact that labor forces cannot be easily reduced offers a partial explanation for the apparent paradox between the price inflation

\* A compensating increase is likely in 1968 in the reserve requirement of commercial banks (now set at 19 percent).

and falling industrial demand which exists in Spain as the reduction in demand suffered by employers is not fully transmitted to global demand through a concurrent reduction of the labor force.)

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Casting a further light on the investment outlook, Embassy officers have recently learned from a high official in the Development Planning Commission that the GOS is more or less reconciled to a continued decline in private investment, at least through the first six months of 1968. To take up some of this slack, the recast Second Development Plan will project substantial increases in public sector investment, primarily in housing and public works. The GOS hopes that the expansionary impact of this public investment activity plus an anticipated increase of some 20 percent in export and tourism earnings will be sufficient to assure a GNP rate of growth of 4.5 percent in 1968. The same Planning Commission official expressed personal doubt, however, that the attainment of even this modest target--which is a substantial reduction from the unrealistic target of 6.0 percent originally set in the Second Plan--will be possible in 1968.

International: The Government's international economic objectives for 1968 stem directly and indirectly from the priority need to regain long-term equilibrium in the balance of payments--a task which requires a narrowing of Spain's huge trade gap. The negotiations with the European Community for some form of Spanish affiliation will continue in 1968 but appear to be proceeding even more slowly than had been anticipated. While Spain had never expected the negotiations to be other than long and difficult, the Spanish were quite obviously disappointed with the EC's first negotiating offer on reciprocal preferences. Spain hopes to obtain a new negotiating mandate from the EC in early 1968, but even within those quarters of the GOS where enthusiasm for affiliation remains highest, there is obviously a more tempered and realistic assessment of the possibilities of obtaining an acceptable accord.

The unlikelihood of reaching an agreement with the EC in the near future while faced with the need for immediate trade improvement undoubtedly accounted for the belated attention given by the GOS to the Kennedy Round negotiations and is also responsible in large part for the increased GOS interest in UNCTAD II. The GOS hopes to implement the tariff concessions of the Kennedy Round, under which Spain was a considerable net winner, by July 1. As further insurance against long delay or failure in the EC negotiations, Spain hopes to obtain the greatest possible benefits out of UNCTAD and will push hard for classification as a recipient country under any system of LDC preferences.

As mentioned above, the Planning Commission has projected a 20 percent increase in export and tourism earnings in 1968. The GOS also appears to plan no increase in imports in 1968, an indication that the restrictive measures of 1967 can be expected to remain in force--a further confirmation of the low investment and growth prospects for 1968.

As a final element in the rather dismal outlook for 1968, the U.S. balance of payments program has come as a severe shock to Spain. While the GOS

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Madrid A-463

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8

may have over-reacted in its preliminary assessment of the impact of the Johnson Program, it is beyond question that the U.S. measures will affect Spain significantly. The Embassy estimates that the direct impact on the Spanish balance of payments of the U.S. program, through loss of U.S. direct investment and tourism earnings, could be in the range of \$75 to \$125 million per year--a loss which would be of great marginal concern to Spain. Moreover, although the indirect effects of the U.S. program as it acts to depress Spain's major trade and tourism markets in Western Europe are even more difficult to assess, and will unquestionably depend in large part on the economic policies pursued by those countries, there is serious concern among some of the technically best informed GOS officials that these indirect effects may exercise more serious effects on the Spanish economy than the direct effects (for which compensating action can more readily be taken). At the very least, it appears likely that whatever balance of payments benefit Spain might have obtained from devaluation will be substantially offset by the direct and indirect effects of the U.S. program.

Thus, it appears virtually certain that Spain will incur its fourth successive payments deficit in 1968. If the effects of the U.S. program are as severe as is feared possible and/or if there should be a shortfall in the planned 20 percent increase in export and tourism earnings--which would have appeared overly ambitious even in the absence of the U.S. program--the deficit could once more rise to the range of the 1967 deficit. Even with a minimal effect from the U.S. program, there will almost certainly have to be an alteration in the constitution of Spanish reserves in 1968. With gold holdings making up some 75 percent of total reserves of about \$1 billion and the balance of payments in a deficit cycle, Spain will probably be forced to sell gold in 1968 in order to carry on normal international operations. Indeed, a knowledgeable IEME official very recently informed Economic officers that various schemes to optimize the benefits of such a reconstitution are under current consideration.

### III. Conclusions: 1968--A Year of Trial

It is difficult to find cause for optimism in viewing Spanish economic prospects for 1968. While rigorous enforcement of the income and price freeze would undoubtedly bring about some reduction in the rate of inflation, there is little prospect (judging from past failures of will on the part of the Government) that such enforcement will be forthcoming. The price effects of the devaluation are only now beginning to be felt and there is imminent danger that adjustment of prices to absorb these effects will severely weaken the existing psychology of restraint. The Government's poor record in past efforts at restraint, its weakened authority arising from its discredited economic programs of recent years, and its continued reluctance to reorder its own spending priorities on a rational and coherent basis make the outlook even more bleak.

Of equal or greater concern is the decline in investment and the slowed growth of production. Should the present state of drift persist, there



is a real danger that the present period of recession will be protracted. A change in economic leadership to restore public confidence and to provide badly needed policy coordination would appear to be a necessary condition of business. But the consensus within as well as outside the Government is that cabinet changes are unlikely during the next several months.

Present conjunctural problems aside, Spain's longer-term economic progress continues to demand the restructuring and modernization of industry, including the elimination of inefficient productive units, priority modernization and reorientation of production in agriculture, and rationalization of nonessential public sector spending. These structural changes are essential not only to balanced domestic growth but they also offer the only visible solution to the balance of payments problem. Spain simply cannot indefinitely continue to import three times as much as it exports. And as the experience of the past three years has shown invisible earnings and foreign capital inflows are not capable of growing at a sufficient rate to cover Spain's rising import demand for foodstuff, raw materials, and capital goods. The only long-term solution is an expansion of exports and substitution of domestic production for imports.

In this regard, the continued lack of serious attention to the needs of the agricultural sector is most alarming. Nearly all GOS officials agree that the development of a healthy agriculture is of the first priority, but lack of effective leadership has again forced the postponement of any serious attack on these problems. The failure to employ the psychology of the 1967 devaluation and austerity program to force reform in the key agricultural sector will in time undoubtedly come to be seen as but one more example of the suicidal unwillingness to grasp this sociopolitical nettle which remains the key to stable economic evolution in Spain.

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